

UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
OFFICE OF ADMINISTRATIVE LAW JUDGES

IN THE MATTER OF:
MALCOLM JOHNSON & COMPANY, P.A.,
MALCOLM P. JOHNSON, and
JIM K. BARKER, JR.,

Respondents.

2003

HUDALJ 03-3015-DB
03-3014-DB
03-3016-DB
Decided: December 8,

David R. Fine, Esq.
Phillip L. Schulman, Esq.
For the Respondents

Maurene Malone, Esq.
Ana Fabregas, Esq.
Dane Narode, Esq.
For the Government

Before: Constance T. O'Bryant
Administrative Law Judge

HEARING OFFICER'S FINDINGS OF FACT

STATEMENT OF THE CASE

This matter is before the Court based on the Government's proposed debarment of Malcolm Johnson & Company, P. A. ("MJC"), Malcolm P. Johnson and Jim K. Barker, Jr., (collectively, "Respondents"), for a period of five years. The proposed debarment is based upon Respondents' alleged acts and omissions in the performance of annual audits for the following public housing authorities ("PHAs") for the periods noted below:

Housing Authority

City of Miami Beach ("HACOMB")
District of Columbia ("DCHA")
New Orleans ("HANO")
Spartanburg
Royston

Audit Year Ended

June 30, 1993 - June 30, 1998
September 30, 1999
September 30, 1999
September 30, 1999
December 31, 1999

Gainesville	March 31, 2000
Philadelphia	March 31, 2000
Cincinnati Metropolitan (“Cincinnati”)	June 30, 2000

BACKGROUND

The U. S. Department of Housing and Urban Development (“HUD” or “the Government”) entered into Annual Contribution Contracts (“ACCs”) with each of the PHAs identified above (Cx¹ -347, 353). Pursuant to these ACCs, HUD awarded millions of dollars in federal funds to the PHAs to maintain public and assisted housing units during the periods at issue in the notice. Tr. 49-50, 61-67.

Pursuant to its ACCs with each PHA, HUD required the PHA to maintain its books and records in such condition that an effective audit could be performed. In addition, the PHAs were required to obtain annual audits by the Single Audit Act Amendments of 1996 (“SAAA”) (P. L. 104-156 (1996)) because they expended \$300,000 or more federal funds per year. Tr. 49-50, 53-54, 61-67.

At the end of its fiscal year, the PHA presents its financial information in a set of financial statements. Tr. 129-30. The financial statements are then given to a Certified Public Accountant (“CPA”) to perform an audit. The purpose of the audit by the CPA is to determine whether there are any material misstatements in the financial statements prepared by the PHA. Tr. 137-38. Through its audit, the CPA is “reducing to an appropriately low level, the risk that the financial statements are materially misstated due to fraud or error.” *Id.* The auditor accomplishes this by focusing on specific audit objectives that are required by applicable auditing standards, and by performing tests to achieve these objectives. Tr. 138.

HUD uses these audits to: 1) assess the financial condition of the PHA during the year; 2) assess the PHA’s compliance with law and HUD’s regulations; 3) monitor the use of public funds through the HUD field offices; 4) enable HUD to enforce program requirements; and 5) determine whether the PHA is providing decent, safe and sanitary housing to residents. Tr. 68-69, 78. Additionally, HUD uses these audits to assign a

¹References to the Government’s exhibits are indicated by Cx-#, to Respondents’ exhibits by Rx-#, and to the hearing transcript by Tr. #.

numerical score and rank to the PHA according to the risk they pose to HUD, which rankings allow HUD to use its limited resources and staff to focus its attention on those

PHAs most in need of assistance. An unreliable audit places HUD funds and the fulfillment of its mission at risk. Tr. 69-71.

MJC is an auditing firm in DeBary, Florida, that focuses its practice on auditing public housing authorities. Malcolm J. Johnson is the president of MJC and has been for all times relevant to these findings of fact. Jim K. Barker, Jr., is the vice president of MJC and has been for all times relevant to these findings of fact. Both Mr. Johnson and Mr. Barker are CPAs.

MJC contracted to perform the annual audits for each of the eight housing authorities included in the Complaint. Pursuant to its contracts with the PHAs, MJC agreed to perform the audits for Cincinnati, DCHA, Gainesville, HANO, Philadelphia, Royston, and Spartanburg in accordance with Generally Accepted Auditing Standards (“GAAS”),² and Generally Accepted Government Auditing Standards (“GAGAS”).³ (Answer, ¶¶ 7, 30, 54). MJC also contracted to perform the audits for Cincinnati, DCHA, Gainesville, HANO, Philadelphia, Royston, and Spartanburg in accordance with the Office of Management and Budget (“OMB”) Circular A-133 and its Compliance Supplement.⁴ Answer, ¶¶ 7, 30, 54.

In each of the audits, Respondents were to determine whether the financial statements for the fiscal year under audit fairly represented the financial position and the results of the financial operations of the PHA, and whether the PHA had internal accounting and other control systems in place to provide reasonable assurance that it was

²GAAS are the standards that are promulgated by the American Institute of Certified Public Accountants (“AICPA”). Tr. 135. There are ten GAAS. Currently there are 101 Statements on Auditing Standards (“SAS”). There are also Statements of Position (“SOP”) or interpretations of the auditing standards that discuss the application of GAAS. Through SAS 74 and SOP 98-3, an auditor is required under GAAS to comply with GAGAS if he/she is performing an audit in which GAGAS applies. Tr. 111-112, 116, 135.

³GAGAS are auditing standards that apply to audits of entities expending federal funds. Tr. 135-36. GAGAS are set by the Governmental Accounting Standards Board of the U. S. General Accounting Office. *Id.* GAGAS incorporates the requirements of GAAS, but adds some additional requirements. Tr. 111-12.

⁴ OMB Circular A-133 implements the requirements of the Single Audit Act Amendments of 1996. Tr. 61. Circular A-133 sets forth the tests and suggested procedures that the auditor has to perform to reach an opinion as to whether the entity has complied with the laws, regulations, and other requirements. Tr. 136, 171-172.

managing Federal financial assistance programs in compliance with applicable laws and regulations and the requirements of GAAS, GAGAS and OMB Circular A-133.

MJC performed the audit for each of the PHAs listed in the Complaint and submitted them to the PHAs. Tr. 62-67. All the audits were submitted between August 10, 2000 and October 31, 2001.

HUD's Departmental Enforcement Center first reviewed the audit reports as part of a quality control review. On October 9, 2002, HUD served on MJC, Mr. Johnson and Mr. Barker notices of proposed debarment from participating in procurement contracts with HUD for a period of five years. The notices alleged violations of applicable professional auditing standards and principles relating to the audits in question. HUD cited as grounds for the debarment serious deficiencies in Respondents' performance as an independent public accountant performing audits for the PHAs listed above.

After an informal hearing conducted in December 2002, by the debarring official's designee, the debarring official decided to debar Respondents for 5 years. Respondents made a timely request for hearing and the matters were consolidated for hearing.

On January 10, 2003, HUD's Debarring Official referred the matter to this tribunal for hearing. Section 24.314(b)(2)(i) of 24 C.F.R. authorizes the Debarring Official to refer "disputed material facts and issues of law to a hearing officer for findings of fact and conclusions of law," but the Debarring Official referred the case for findings of fact only.

On February 5, 2003, HUD served on MJC, Mr. Johnson and Mr. Barker supplemental notices of proposed debarment. These supplemental notices added additional allegations regarding false certifications to the PHAs. HUD subsequently filed and served a single notice, consolidating the three supplemental notices of proposed debarment. That document (the Supplemental Notice) will be referred to as the Complaint in this case.

By agreement of the parties, an evidentiary hearing was held more than 45 days after the original referral of the case by the Debarring Official. *See* 24 C.F.R. § 24.314 (b)(2)(ii). The hearing was held on April 12, 13, 14, 15 and 17, 2003, in Orlando, Florida. At the close of the hearings, the parties were directed to file briefs. The last brief was received on June 18, 2003. These findings have not been issued within the period contemplated by 24 C.F.R. §24.314(b)(2)(ii) because the record is relatively large, and because of interruptions caused by the illness and subsequent death of my mother.

After consideration of all the evidence, I find that the Government failed to prove by the preponderance of the evidence that Respondents failed to comply with GAGAS, or GAAS, or OMB Circular A-133 in connection with the audits alleged in the Complaint. It also failed to establish that Respondents showed a lack of due professional care or submitted false certifications in connection with the same audits.

ANALYSIS

The Complaint alleges that Respondents failed in connection with audits performed for eight PHAs to comply with auditing standards contained in GAAS, GAGAS, and OMB Circular A-133. More particularly, the Complaint alleges the following deficiencies:

- I. MJC failed to adequately plan the audits. (Complaint ¶¶ 71-79)
- II. MJC failed to properly staff and supervise the audits. (Complaint ¶¶ 80-81)
- III. MJC failed to properly perform or document performance of procedures for internal control. (Complaint ¶¶ 82-84)
- IV. MJC failed to make sufficient inquiry, obtain sufficient evidence, perform sufficient examination of the evidence, and/or document its work to support its conclusions. (Complaint ¶¶ 85-91)
- V. MJC failed to properly test for compliance under OMB Circular A-133. (Complaint ¶¶ 92-93)
- VI. MJC failed to properly document the work performed in its working papers. (Complaint ¶¶ 94-98)
- VII. MJC failed to properly opine or report on the audits. (Complaint ¶¶ 98-108)
- VIII. MJC failed to exercise due professional care. (Complaint ¶ 109), and
- IX. MJC caused the submission of false statements to HUD. (Complaint ¶¶ 110-111)

Expert witness testimony was allowed to assist the court in understanding the evidence. *See* Federal Rules of Evidence, (“Fed. R. of Evid.”) Article VII, Rule 702. The auditing standards at issue are quite complicated. Therefore, the testimony of a witness qualified as an expert by knowledge, skill, experience, training or education, is important and necessary to assist the court in determining whether the auditing reports fall short of applicable standards. *See Hodge v. D. C. Housing Finance Agency*, 1993 U. S. Dist Lexis 14584 (Dist. Ct for the District of Columbia, 1993) (GAAS and GAGAS are “quite complicated,” are “not within the ‘common knowledge’ of jurors” and “require proffer of expert testimony.”)

Both parties agree that the decision in this case should turn on the experts’

testimony.⁵ The opinion of the Government's expert contrasts sharply with that of Respondents' experts. Respondents argue that the testimony of the Government's expert is not competent and should be excluded or discredited by the court.

The Experts

Three witnesses gave testimony in this case - - Don Pallais testified for the Government and Rhett Harrell and William Holder testified for Respondents. All are CPAs.

I allowed the Government's witness - - Mr. Pallais - - to testify as an expert on compliance with GAAS, GAGAS and OMB Circular A-133 over the strenuous objection of Respondents. Tr. 121. Respondents argued that Mr. Pallais is qualified only as an expert in GAAS and not in GAGAS and OMB Circular-133. Post-trial, Respondents moved the court to reconsider its ruling qualifying Mr. Pallais as an expert in GAGAS and OMB Circular A-133. Additionally, Respondents argue that Mr. Pallais' testimony is unreliable as to all standards, including GAAS, because he did not consider all the relevant evidence available to him during his review of Respondents' audits.

The qualifications of Respondents experts in the areas of GAAS, GAGAS, and OMB Circular A-133 have not been challenged by the Government. Accordingly, only the qualification of Mr. Pallais is at issue.

⁵ "The question of whether the audits identified in the Notice violated HUD requirements rests primarily on the testimony of the parties' experts." *See* Government's Brief at pp. 7-8. "The standards applicable to this case (GAAS, GAGAS, GAAP and OMB Circular A-133) are sufficiently complex that the Court should require expert testimony to prove any non-compliance with them." Respondents' Brief at p. 7.

Both Mr. Pallais and Mr. Harrell reviewed the audits HUD had found deficient. Mr. Pallais testified that in his professional opinion the audit work did not meet the requirements of GAAS, GAGAS, and OMB Circular A-133. TR. 179, 342-350, 376-78. It was Mr. Harrell's professional opinion that Respondents' audits had not violated any of the above standards.⁶

Mr. Pallais' testimony

Mr. Pallais' testimony shows that he spent approximately 100 hours reviewing the papers documenting the audits in this case. In his review of the audits, Mr. Pallais read the reports, and all the work papers, including related correspondence. He analyzed the work papers to determine the scope of their testing and the results. He looked to determine whether the work conformed to the standards applied in the circumstances, whether the work supported the conclusion the CPA came to, and whether there was a reasonable basis for each of the reports issued. Tr. 126-128.

Mr. Pallais concluded that there were significant failures in the audit reports in six general areas: planning, procedures for internal control, evidence gathering, failure to document the work, failure to properly report findings and compliance with OMB Circular A-133. It was his opinion that Respondents failed to comply with the requirements of GAAS and GAGAS in all these areas. His testimony was that at no point did MJC document in the working papers that it had done what was required by the applicable standards. Tr. 180.

Mr. Harrell's testimony

⁶ Mr. Holder did not review the audits which are the subject of the Complaint, but rather testified regarding the quality of more recent audits performed by Respondents with reference to Respondents' "present responsibility."

The Departmental Enforcement Center first reviewed Respondents' audit reports as part of a quality control review. It notified Respondents that the audits did not meet generally accepted auditing standards. Concerned about the notice and its negative findings, Respondents engaged the services of Mr. Harrell as an expert accountant to advise them as to whether there was merit to the Government's contentions that they had violated professional standards in their audits of the PHAs in question. Rx-7, 8.

Mr. Harrell spent approximately 15 hours conducting the consulting review and prepared a written opinion on the audits. After review of the alleged violations, Respondents audit work papers, and communications with Respondents Johnson and Barker about the audits, Mr. Harrell disagreed with the Government in all significant respect about the audits. It was his professional opinion that the audits were consistent with generally accepted auditing principles and the requirements of GAAS, GAGAS, and OMB Circular A-133. Rx-8.

At trial, Mr. Harrell reiterated his expert opinion that the audits of the PHAs in question complied with GAAS, GAGAS, and OMB Circular A-133.

The Government argues that Mr. Pallais performed a more thorough, in-depth review of MJC's audit reports and working papers than Mr. Harrell, that he supported his opinion with reference to specific documentation or evidence in a way that Mr. Harrell did not, and that he is a more reliable witness on all aspects of the case. Accordingly, the Government urges the adoption of Mr. Pallais' opinion.

Finding compelling reason to do so, I reconsider my trial ruling finding that Mr. Pallais was qualified by specialized knowledge and experience to give expert testimony on whether Respondents' complied with the standards of GAGAS and OMB Circular A-133.

Qualification of Mr. Pallais as expert on GAGAS and OMB Circular A-133

Under the Federal Rules of Evidence 702 ("Fed. R. Evid"), a party who sponsors the witness must establish by a preponderance of the evidence that he is qualified as an expert and that the expert's testimony is admissible. The trial judge must ensure that any and all expert testimony admitted is not only relevant but rests on a reliable foundation. "Rules 702 and 703 grant all expert witnesses testimonial latitude unavailable to other witnesses on the 'assumption that the expert's opinion will have a reliable basis in the knowledge and experience of the discipline.'" *Kumho Tire Co., Ltd., et al v. Carmichael, et al*, 526 U. S. 137 at 139, *citing Daubert*, 509 U. S. at 592. *See also Diaz v. Johnson Matthey, Inc.*, 893 F. Supp. 358, (Dist. of N.J., 1995) (the court must determine whether the testimony is reliable, i.e., whether the expert has "good grounds"

for his or her opinion). The trial judge has broad latitude to determine reliability. *Kumho*, 526 U. S. at 143.

The requirements of GAAS are set by the American Institute of Certified Public Accountants, (“AICPA”). Mr. Pallais’ qualification as an expert in GAAS is not challenged. The requirements of GAGAS are set by the Governmental Auditing Standards Board of the Government Accounting Office (“GAO”). These standards apply when federal money is involved. All PHAs have to comply with GAGAS. Tr. 125-36.

Mr. Pallais testified that he worked for AICPA for nearly six years ending about 1991. While at the AICPA, he was Director of the Auditing and Accounting Guides and for the years 1989, 1990, and 1991 served on the Auditing Standards Board. He co-authored eight accountants’ reference books, including a guide to GAAS. He has published over 20 articles on accounting and auditing topics for professional journals.

Mr. Pallais agreed that one could be an expert in GAAS, without being an expert in GAGAS, but indicated that learning the GAGAS requirements is not a major effort once a practitioner knows GAAS. Tr. 114. GAGAS subsumes GAAS, with GAGAS having only a few additional requirements than GAAS. It was Mr. Pallais’ testimony that every requirement in GAGAS is in GAAS by virtue of Statement on Accounting Standards (“SAS”) 74 and Statement of Position (“SOP”) 98-3. Tr. 114. In the case where the audit is of a governmental unit, as in the instant case, in order to comply with GAAS, the audit report must comply with GAGAS. Thus, compliance with GAAS requires that a practitioner who is performing an audit of a governmental unit comply with the additional requirements of GAGAS.⁷

⁷When Mr. Pallais was asked how GAAS related to GAGAS, he gave the following answers:

GAGAS subsumes GAAS. In addition, Statement on Auditing Standards number 74 requires and subsumes GAGAS for the purpose of audits of companies to which they apply. So in order to comply with generally accepted auditing standards [GAAS] for a company -- for an auditor that must comply with generally accepted government auditing standards [GAGAS], he must also comply with that second set of standards. . . . GAGAS, the government auditing standards have additional requirements on top of GAAS. You must do everything in GAAS, plus about three more things. And, but its sort of confusing because its interrelated. You cannot comply with GAAS for a government unit, or in this case the Public Housing Authority, unless you’ve also complied with GAGAS. Tr. 111

Q. You can’t comply with GAGAS without complying with GAAS?

A. Both. It is circular. . . . There’s a provision in GAGAS that says you must . . . comply with GAAS. There is a provision in GAAS that says you must comply with GAGAS. So, in either case, you cannot comply with GAAS without complying with GAGAS. Tr. 112.

When asked if one could violate GAGAS without violating GAAS, he answered “Technically, no. . . . If

Mr. Pallais testified that although he had never participated in the audit of a PHA, had no experience within the last 20 years in the audit of a local governmental unit, and had never testified as an expert on GAGAS standards, that he was well familiar with the GAGAS requirements. Tr. 109, 118. He became familiar with the GAGAS requirements during the nearly six years he worked on the Auditing Standards Board of the AICPA. While at the Board he was involved in the drafting of SAS-74 and its predecessor, SAS-68, which included a detailed discussion of GAGAS requirements. Tr. 119-120. It was his testimony that although the requirements for audits of governmental units had been modified over the years, “conceptually it hasn’t changed in a long time. The basic thrust of GAGAS has been the same for almost twenty years.” Tr. 123, 135-136.

Similarly, with regard to OMB Circular A-133, Mr. Pallais testified that he had written no articles or books on the subject and taught no courses. His only exposure to OMB Circular A-133 came from having read it. Tr. 124. However, he stated that he was very familiar with its predecessor, Circular A-128, when he worked at the AICPA. This Circular sets forth what type of tests the auditor has to perform to satisfy him/herself that a unit has complied with the particular organization’s needs. Tr. 136. It was his testimony that testing for compliance under OMB Circular A-133 was no different than testing for compliance under any other requirements standards. “A-133 is no different than any other set of criteria against which the auditor tests compliance.” Tr. 122.

Based on the strength of Mr. Pallais’ testimony that he gained specialized knowledge of the GAGAS and OMB Circular A-133 requirements during his work at the AICPA, and that the requirements had not significantly changed over the years, and relying upon the broad latitude granted courts to determine reliability, I allowed Mr. Pallais to testify as an expert in GAGAS and OMB Circular A-133, over Respondents’ objection.

GAGAS applies and you violate it, you’ve also violated SAS - 54 - 74, so you’ve also violated GAAS. It’s impossible to violate GAGAS without also violating GAAS. It can’t be done.” Tr. 115.

Mr. Pallais testified that the GAGAS requirements had not changed in any significant way since he was at AICPA in 1991. At that time, auditing standards prohibited the audit reviewer from orally seeking supplemental information regarding audit work papers from the audit preparer. However, Respondents' experts, Mr. Harrell and Mr. Holder, gave testimony that completely undermines Mr. Pallais' testimony on this point and consequently undermines the reliability of Mr. Pallais' opinions regarding violations of GAGAS. Both Mr. Holder and Mr. Harrell, witnesses whose expertise in GAGAS and OMB Circular A-133 is unchallenged in these proceedings, testified to a change in the GAGAS requirements in 1994.

According to Mr. Harrell and Mr. Holder, Mr. Pallais applied the Yellow Book⁸ standard of professional judgment that was in effect in 1989 in his analysis of Respondents' audits. That standard required that practitioners' work papers stand on their own so that they required no oral explanation. It prohibited reviewers from seeking oral supplementation or clarification of work papers. However, auditors found that policy to be "unworkable." The requirements were, therefore, modified in 1994 to remove the prohibition against seeking oral evidence or clarification. Tr. 693-95; 855. Since 1994, the Yellow Book standard has allowed oral explanation by the practitioner of his/her work papers. Both testified that it is unfair to Respondents to conclude that their audits do not meet professional standards without giving them an opportunity to explain and/or clarify their work product.

Although Mr. Pallais testified during the Government's rebuttal case, his testimony strikingly failed to contest Mr. Holder's and Mr. Harrell's testimony regarding the appropriateness of consideration of oral explanation and clarification of the audit papers, or to comment on why he did not attempt to obtain such an explanation from the Respondents of problems he found with the work papers. He was silent on the issue. His failure to defend the thoroughness of his analysis leads me to conclude that Mr. Holder and Mr. Harrell were correct in their testimony and that Mr. Pallais' analysis was

⁸GAGAS requirements were published in the 1994 "Yellow Book," so called because of the yellow color of the book version published by the federal government.

seriously deficient. The conflict in testimony between Mr. Pallais on the one hand and Messrs. Harrell and Holder on the other, falls “outside the range where experts might reasonably differ.” *See Kumho*, 526 U.S. at 141.

I find credible Respondents’ experts’ testimony that a fundamental change occurred in the GAGAS requirements beginning after 1994, and their testimony that in his review of the case, Mr. Pallais relied upon a GAGAS audit standard that had been discarded more than five years before the audits in question. This error is so egregious as to undermine Mr. Pallais’ qualification as an expert on GAGAS in this case. Either Mr. Pallais did not know about this crucial change in GAGAS requirements, or he chose to ignore it and mislead the court. In either case, his failure to acknowledge the change is reason to find his testimony unreliable and to disregard his opinion concerning Respondents’ compliance, or lack thereof, with the requirements of GAGAS.

Moreover, although it seems clear from the evidence that Mr. Pallais performed a far more thorough review of the *written* documentation which supported the audits, he admitted that he did not make any inquiries of Respondents about the audits they performed. Tr. 694 - 696, 854. His failure to know about (or to apply in his analysis) the revised standard of GAGAS is a fatal deficiency in his testimony regarding Respondents’ alleged violation of the requirements of GAGAS.

Other Indicia of Unreliability of Mr. Pallais’ testimony

The Government began its review of Respondents’ work in 2001 by sending a review team to MJC in DeBary, Florida. Tr. 621. After its review of the same work papers that Mr. Pallais later examined, the team issued a “results letter” to Respondents. Rx-1. The majority of the allegations in the “results letter” also appear in the Complaint. Tr. 621. In the fall of 2001, HUD sent the “results letter” as a formal complaint to the boards of accountancy of at least five states in which Respondents practiced. Tr. 624-25; Rx-33, Rx-38. As of the date of the close of the record, not one of the licensing boards had indicated that it agrees with the alleged violations. Indeed, two of the states expressly rejected such a finding.⁹ The failure of these state accountancy boards to find violations of generally accepted accounting standards weighs heavily against the position taken by Mr. Pallais and the Government. *See In re Damaskos*, HUDBCA No. 93-C-D32 (Oct. 14, 1993). I therefore conclude that Mr. Pallais’ testimony regarding Respondents’

⁹The Louisiana State Board of Certified Public Accountants determined that “there was no cause for action” and closed its file. Rx-34. The Florida Department of Business and Professional Regulation dismissed the complaint “without a finding of probable cause.” Rx-36. There is no evidence that the accountancy boards in South Carolina, Ohio, and Georgia took any substantive action on the complaints.

violation of GAGAS is not reliable and that his analysis was both unfair to Respondents and fatally flawed. Tr. 694-96; 854.

Rule 702 grants the trial judge the discretionary authority, reviewable for its abuse, to determine qualification as an expert in light of the particular facts and circumstances of the particular case. *See Kumho* 526 U. S. 137 (1999). After considering the record and the arguments, I conclude that my ruling qualifying Mr. Pallais as an expert in GAGAS and OMB Circular A-133 was improvidently made. At issue is not his qualification as an expert in general accounting principles, but whether he could reliably determine whether Respondents violated the requirements of GAGAS and OMB Circular A-133, as alleged in the Complaint. Where the expert's "factual basis, data, principles, methods, or other application are called sufficiently into question, . . . the trial judge must determine whether the testimony has a 'reliable basis in the knowledge and experience of the [relevant] discipline.'" *Kumho*, citing *Daubert*, 509 U. S. 589 at 592.

I conclude that Mr. Pallais' testimony on compliance (or the lack thereof) with requirements of GAGAS, and OMB Circular A-133 should be excluded as unreliable, based on the facts and circumstances in this case. The overall evidence shows that he did not have good grounds for his opinion. I, therefore, grant Respondents' motion to reconsider the ruling qualifying Mr. Pallais as an expert in determining compliance with GAGAS and OMB Circular A-133 and reverse my ruling. I find that Mr. Pallais is not qualified to give expert opinion evidence in the case regarding whether Respondents violated the standards of GAGAS and OMB Circular A-133. *See* Tr. 109, 114-118, 124, 675, 681-82, and 697.

Even if I were to conclude that Mr. Pallais was minimally qualified through his work, training and experience to testify as an expert regarding compliance with GAGAS and OMB Circular A-133, I would still exclude his testimony because it demonstrates insufficient indicators of reliability of his opinions when examined within the context of all of the evidence of record.

With Mr. Pallais' testimony excluded from the record, the Government has failed to produce expert testimony showing that Respondents failed to meet the auditing requirements of GAGAS. Only the uncontested expert testimony of Mr. Harrell that the audits complied with the requirements of GAGAS remains. As to the requirements of OMB Circular A-133, I credit the testimony of Mr. Harrell, whose credentials as an expert in determining compliance with OMB Circular A-133 have not been challenged, that the audits in question complied with those standards. Accordingly, the Government has failed to establish by a preponderance of the evidence any failure to comply with the accounting requirements of GAGAS and of OMB Circular A-133.

Mr. Pallais' testimony as to violations of GAAS

Mr. Pallais testified that the eight audits in question did not comply with the requirements of GAAS. Mr. Harrell testified that in his expert opinion the audits in question complied with the auditing requirements found in GAAS.

The Government relies upon Mr. Pallais' testimony to establish a violation of the Complaint paragraphs alleging violation of standards of GAAS. Although Respondents do not challenge Mr. Pallais' qualification as an expert in this area, they argue that his testimony is less credible than the testimony of Respondents' expert (Mr. Harrell) and that the preponderance of the evidence does not show any violations of the GAAS accounting standards. I agree.

Mr. Pallais testified that during the period relevant to this inquiry, GAAS, as applied to nongovernmental units, had no specific documentation requirements, but that GAGAS did. He testified that by virtue of GAAS' SAS-74, in cases involving audit of a governmental unit, the strict documentation standards required by GAGAS were incorporated into the GAAS requirements because an auditor could not comply with GAAS in an audit of a governmental unit unless the auditor also complied with

GAGAS.¹⁰ Tr. 111, 177. For the audits of the PHAs in question, it was Mr. Pallais' opinion that GAAS, like GAGAS, required the audit workpapers to stand on their own without oral explanation.¹¹

¹⁰ According to Mr. Pallais, "every requirement in GAGAS is also in GAAS by virtue of both SAS - 74 and Statement of Position 98-3. So it would be impossible to violate GAGAS without also violating GAAS." Tr. 177. *See also* fn 7, *infra*.

¹¹ With regard to documentation requirement under GAAS, Mr. Pallais testified as follows:

For years and years and years, there were no specific documentation requirements in generally accepted auditing standards (GAAS), . . . left it totally up to auditor judgment. And after a while, we [AICPA] decided we needed some specific requirements, because people were doing audits and not documenting a lot . . . And the generally accepted auditing standards (GAAS) have been moving more and more in that direction over the last twenty years. Tr. 175-176.

Essentially, GAGAS is now and has been for years where GAAS is now heading. Tr. 176-177 . . . So there, the documentation requirements under GAGAS require some very explicit things, including that the work papers show the objective, scope, methodology, and sampling criteria used, the detail of evidence examined, so that an auditor can come in after you, and look at the same transaction you looked at and the same records that you looked at . . . So the work papers should be sufficient to allow an experienced auditor to come in, having no relationship whatsoever with this PHA, and know exactly what you did.

So it's a higher documentation standard. But frankly, it is where GAAS has been heading. And after a standard that was issued last year, but wouldn't apply to the engagements in question here, is pretty much where GAAS is now. But it wasn't at the time of these engagements. But GAGAS did have these requirements. Tr. 177

As previously discussed, the testimony of Mr. Harrell and Mr. Holder establishes that Mr. Pallais erroneously relied upon a GAGAS audit standard that had been discarded more than five years before the audits in question. Accordingly, Mr. Pallais applied an incorrect standard in analyzing alleged GAAS violations. Since 1994, oral supplementation has been a regular part of reviews of a practitioner's audits. Indeed, both Mr. Harrell and Mr. Holder testified that it would be unfair to practitioners to conclude that their audits do not meet professional standards without giving them an opportunity to explain and/or clarify their work product.

I credit Mr. Harrell's testimony that it was proper to consider oral explanations regarding the audits in determining compliance with GAGAS and GAAS and I reject Mr. Pallais's contrary opinion. The propriety of Mr. Harrell's conclusion was supported by Mr. Holder's testimony.

Mr. Pallais' testimony was challenged in other significant instances by both Mr. Harrell and Mr. Holder. Mr. Pallais testimony appears to assume that a violation of one of the Statements on Auditing Standards ("SAS") is equivalent to a violation of a GAAS. Tr. 1003. There are 10 GAAS and 101 SAS. Repeatedly, Mr. Pallais testified that Respondents had violated one of the SAS. *See* Tr. 154, 208, 209, 212, 229, 241, 312, 335, 339-40, 368, and 373-375.

Both Mr. Holder and Mr. Harrell testified that Mr. Pallais was mistaken in his assumption. According to their testimony, the SAS serve as authoritative interpretations of the standards, but they do not carry the same authority as the standards themselves, and a violation of one of the SAS does not necessarily mean a violation of one of the GAAS. Tr. 689-90, 855-56. Mr. Pallais' testimony was internally inconsistent on this point. During the Government's case-in-chief, he testified that in the hierarchy of authority, the SAS are *below* the actual standard. Tr. 135. However, on rebuttal he testified that the SAS are *equivalent* authority to the standards themselves. Tr. 1003.

I credit Mr. Holder's and Mr. Harrell's testimony that a violation of one of the SAS does not necessarily mean a violation of GAAS and find that a violation of one of the SAS does not equate with a violation of the GAAS. Therefore, Mr. Pallais' opinion that a GAAS was violated based solely on a violation of the SAS lacks sufficient probative value to satisfy the Government's burden of proving a violation of the GAAS in question.

Accordingly, I find that although Mr. Pallais was qualified as an expert to give opinion evidence regarding possible violation of GAAS, his testimony that Respondents'

audits did not comply with GAAS is not reliable or creditworthy. I credit Mr. Harrell's testimony that Respondents' audits did not violate the requirements of GAAS. I find that the Government has failed to establish that Respondents' audits at issue in this case failed to comply with the requirements of GAAS.

OTHER

The Government presented no evidence supporting a violation of the Complaint charges at ¶¶ 73, 75, 76, 78, 81 and 104. *See* Tr. 397-398, 402-403.

Paragraphs 110 and 111 of the Complaint charge Respondents with a lack of due professional care and submission of false certificates to HUD. If the allegations in paragraphs 71 - 109 of the Complaint that Respondents violated GAGAS, GAAS, and OMB Circular A-133 had been proved, then the allegations in paragraphs 110 and 111 would also have been proved. Because the Government failed to prove those predicate charges, the proof of paragraphs 110 and 111 likewise failed.

Since I find that the Government has failed to establish by a preponderance of the evidence any of the allegations of fact set out in paragraphs 71 - 111 of the Complaint, I need not consider whether there are mitigating circumstances in this case, or whether there is evidence of "present responsibility."

FINDINGS OF FACT

1. The Government's witness, Don Pallais, used an incorrect standard in making his analysis of whether Respondents failed to comply with the requirements of GAGAS, OMB Circular A-133, and GAAS. His testimony does not provide reliable evidence of the violations alleged in Charges ¶¶ 71 - 109.
2. Expert witnesses Rhett Harrell and William Holder gave reliable and creditworthy testimony in this case. I credit Mr. Harrell's professional opinion that all of the audits performed by Respondents for the PHAs charged in ¶¶ 71 - 109 complied with the requirements of GAAS, GAGAS, and OMB Circular A-133.
3. The Government failed to prove by a preponderance of the evidence that Respondents violated any requirement of GAGAS, GAAS, or OMB Circular A-133 as charged in the Complaint, ¶¶ 71 - 109.
4. The Government failed to prove by a preponderance of the evidence that

Respondents showed a lack of due professional care or that Respondents submitted false certifications as charged in Complaint ¶¶ 110 and 111.

Dated this 8th day of December, 2003.

CONSTANCE T. O'BRYANT
Administrative Law Judge

CERTIFICATE OF SERVICE

I hereby certify that copies of this **HEARING OFFICER'S FINDINGS OF FACTS** issued by CONSTANCE T. O'BRYANT, Administrative Law Judge, in HUDALJ 03-3014-DB, 03-3015-DB, and 03-3016-DB, were sent to the following parties on this 8th day of December, 2003, in the manner indicated:

Chief Docket Clerk

REGULAR MAIL:

Phillip L. Schulman, Esq.
Kirkpatrick & Lockhart
1800 Mass. Avenue, N.W., 2nd Floor
Washington, D. C. 20036

David R. Fine, Esquire
Kirkpatrick & Lockhart, LLP
Payne Shoemaker Building
240 North Third Street
Harrisburg, PA. 17101-1507

April L. Boyer, Esq.
Miami Center - 20th Floor
201 South Biscayne Boulevard
Miami, Florida 33131

INTEROFFICE MESSENGER:

Dane Narode, Esq.
Amy Brown, Esq.
Maura Malone, Esq.
Ana I. Fabregas, Esq.
John W. Herold, Esq.
Todd P. Maiberger, Esq.
Philip A. Kesaris, Esq.
U.S. Department of Housing and

Urban Development
Portals Building, Suite 200
1250 Maryland Avenue, SW
Washington, DC 20410

Tammie Parshall, Docket Clerk
Departmental Enforcement Center
U.S. Department of Housing and Urban Development
Portals Building, Suite 200
1250 Maryland Avenue, SW
Washington, DC 20410

Mr. Pallais testified that in each of the 8 PHAs at issue, the Respondents failed to comply with GAAS, GAGAS and OMB Circular A-133. Tr. 376-78. See also Tr. 179, 342-350

Regarding GAAS, the Respondents failed to meet: the First Standard of Field Work which requires that the auditor properly plan the audit; the Second Standard of Field Work which require that the auditor perform procedures for internal control; and the Third Standard of Field Work that requires that the auditor gather sufficient evidence to support the audit. Id.

Respondents also failed to comply with OMB Circular A-133. Tr. 377-78

Failures:
in planning,
procedures for internal control
evidence gathering
to document work performed
to properly report work performed. Tr. 179

Failed to document work performed Tr. 378
in violation of the 1st, 2nd, and 3rd standards of field work under GAAS
and the documentation standard under GAGAS. Tr. 378

Failed to properly report in violation of 1st, 3rd, and 4th standard of reporting under ?

Also, violated the standard of due care which is in the 3rd standard under GAAS

Vast majority of his opinions had to do with the documentation requirements of GAAS.
Tr. 182. Documentation requirements of both GAAS and GAGAS